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H For CODEL SHELBY

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SUBJECT: SCENESETTER FOR SEPTEMBER 3-6 VISIT OF CODEL SHELBY TO THE UNITED KINGDOM

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¶1. (SBU) The UK government is eager to share viewpoints on financial services reform, and to ensure that U.S. and UK regulations complement each other with the goal of ensuring a vital and thriving financial services industry - critical to both our countries' economic recovery and growth. (Post has separately sent the schedule, along with biographies to military aide and to the chief of staff to Senator Shelby.)

¶2. (SBU) UK government officials are concerned about economic recovery and are questioning whether recent positive signs in the U.S. and Europe indicate that the worst is over. The Labour and Conservative Parties have recently released white papers outlining their vision for UK regulatory architecture. Labour would give the Financial Services Authority (FSA) a formal, statutory objective for financial stability. The Conservatives plan to abolish the FSA and centralize banking regulation authorities in the Bank of England while creating a separate Consumer Protection Agency.

¶3. (SBU) The Financial Services Authority, the Treasury Select Committee and the bankers are concerned about actions in Brussels. The UK is concerned that regulations originating in Brussels would, perhaps as an unintended consequence, most adversely affect the UK. They point to the draft hedge fund directive; the bankers are also concerned about moves to regulate pay and bonuses. Internationally, the UK is pushing for an agreed mechanism for resolving failed multinational banks.

Overview of UK Economy

¶4. (U) The UK officially entered recession in the third quarter of 2008 and has suffered a cumulative contraction of 5.7 percent over the last five quarters. In July, the IMF forecasted contraction of 4.2 percent in 2009 and growth of 0.2 percent in 2010. The OECD projected UK output would decline by 4.3 percent in 2009 and would see zero growth in 2010. HM Treasury expects a contraction of 3.5 percent in 2009 and growth of 1.25 percent in 2010. Unemployment stands at 7.8 percent, its highest since 1995, and is expected to climb to more than 10 percent in early 2010. Unemployment is particularly acute among 18-to-24 year olds at 17 percent. The economic downturn is taking a heavy toll on trade. According to U.S Commerce Department and US International Trade Commission monthly trade statistics, U.S. goods exports to the UK declined by 21.7 percent from Jan. to June 2009, compared to the same period in 2008, and UK exports to the US declined by 25.6 percent.

¶5. (U) Credit conditions are easing. The Bank of England's latest Credit Conditions Survey found lending to the corporate sector increased during the second quarter of this year, as did the availability of secured credit to households. Small businesses and homeowners, however, still find it difficult to find financing at reasonable rates. Chancellor of the Exchequer Alistair Darling

called together CEOs of major banks on August 8 to criticize them for not passing on the lower rates to customers and not increasing their lending.

¶6. (U) Public debt stands at GBP 800 billion, at 56.8 percent of GDP, its highest level since records began in 1974, up from 56.6 percent last month. However, UK debt as a percentage of GDP is still lower than the same percentage in the other G7 countries. CPI inflation was stronger than expected in July, remaining at 1.8 percent. Consumer confidence is up one point since June and up 11 points since July 2008.

UK Government Actions to Address the Crisis

¶7. (U) The UK Government (HMG) has responded to the financial crisis with a three-step plan: bank recapitalization, monetary and fiscal stimulus, and credit stimulus.

¶8. (U) Bank Capitalization: In October 2008, Chancellor Darling provided a GBP 50 billion capital injection into 8 UK banks and the largest building society (Abbey, Barclays, HBOS, HSBC, Lloyds, Nationwide Building Society, Royal Bank of Scotland -RBS - and Standard Chartered). HMG also invested GBP 34 billion in RBS, Lloyds and HBOS. In January, HMG converted its equity stake in RBS from preferred to ordinary shares, increasing its stake in the bank to 70 percent. In recent weeks, HSBC PLC, Lloyds Banking Group PLC, Royal Bank of Scotland PLC and Barclays PLC all reported profits in their retail divisions for the first six months of 2009. Since October 2008, the Bank of England's (BOE's) Monetary Policy Committee has cut the UK's benchmark interest rate 450 basis points from 5 percent to 0.5 percent, the lowest in its 315-year history.

¶9. (U) In November 2008, HMG announced a GBP 20 billion stimulus package including a reduction in value-added tax (VAT) from 17.5

percent to 15 percent for one year, expected to put GBP 12.4 billion into the economy. HMG also introduced a Homeowners Mortgage Support Scheme and a GBP 200 million Mortgage Rescue Scheme. In May, HMG introduced a scrappage scheme giving GBP 2,000 towards a new vehicle if sellers trade in a car over 10 years old. The VAT cut was criticized for having little effect on sales, the homeowner schemes have helped few because of a lengthy qualification processes, but the car scrappage scheme has been praised for kick-starting the UK's automotive industry.

¶10. (U) In January, to improve access to wholesale funding markets, HMG offered full or partial guarantees to eligible AAA-rated asset backed securities. HMG also extended the drawdown window of its existing credit guarantee scheme (a GBP 150 billion scheme to provide banks with a guaranteed source of funding) from April 9 to December 31. To increase the availability of corporate credit, the Bank of England established an asset purchase scheme to buy high quality assets financed by the issue of Treasury bills. To date, the Bank has purchased GBP 129 billion of assets (primarily gilts) as part of its quantitative easing program, and it is authorized to buy up to GBP 175 billion. The Bank of England also extended its Discount Window Facility, increasing the maximum length of time for asset swaps from 30 days to one year.

¶11. (U) HMG announced an asset protection scheme February 26 to remove uncertainty about the value of banks' past investments, to clean up balance sheets and increase lending in the economy. The scheme provides protection against future losses on banks' riskiest assets, so that the healthier core of their commercial business can continue to lend. Under the scheme, banks pay a fee to have part of their riskier assets protected. If these risky assets result in a loss to the bank, the bank suffers all losses up to a pre-determined amount (called a "first loss"). If losses exceed this "first loss," HMG agrees to cover 90 percent of remaining losses, while the bank is responsible for the balance. In this way, banks retain a portion of the risky asset, but are not dragged down by risky toxic assets of unknown value which may result in a significant, undetermined loss. In return, banks are required to develop a sustainable, long-term pay and bonus policy, consistent with the Financial

Services Authority's Code of Practice. To date, the Royal Bank of Scotland (RBS) and Lloyds Banking Group have entered into deals with HMG.

Financial Services Oversight - HM Treasury's Proposal

¶12. (U) HM Treasury (HMT) published its white paper on reforming financial markets July 8. HMT plans to give the Financial Services Authority (FSA) a formal, statutory objective for financial stability. The shape of the UK's institutional regulatory framework will remain unchanged but HMG will legislate to create a Council for Financial Stability, to be chaired by the Chancellor of the Exchequer.

¶13. (U) The white paper also recommends increasing the quality and quantity of capital held by banks, increasing capital requirements for riskier trading activities, introducing a backstop "leverage ratio" that ensures minimum capital levels are maintained, and increasing liquidity regulation. The FSA will increase the intensity of its supervision of banks through its Supervisory Enhancement Program (SEP), including increased regulatory resources and greater focus on high impact firms. HMT supported the FSA's work on reducing the incentives created for excessive risk-taking by bank compensation structures. The FSA published a code of practice designed to ensure boards implement a remuneration policy consistent with good risk management. The FSA expects two-thirds of bonuses for senior employees to be spread over three years and calls on firms not to guarantee bonuses for individuals for more than one year. Non-compliant firms could face enforcement action or be forced to hold additional capital. Firms are expected to provide the FSA with a pay policy statement by the end of October and the code will take effect from January 2010.

¶14. (U) The white paper outlined a number of other regulatory reforms. HMT will extend the powers of the FSA by providing it with a formal, statutory objective for financial stability and giving it legal authority to set rules to protect wider financial stability. The FSA will be given extended powers to deal with individual institutions through firm-specific interventions and will receive enhanced enforcement powers to deal with market misconduct.

Conservative Party Proposals on Regulation

¶15. (U) Shadow Chancellor George Osborne on July 20 announced the Conservative party proposals for changes to the UK's financial regulatory system. A Conservative government would abolish the UK's

tripartite framework and replace it with a significantly more powerful Bank of England (BOE) and a Consumer Protection Agency (CPA). The BOE would be given responsibility for maintaining financial stability, including the micro-prudential regulation of all significant financial institutions. A new Financial Policy Committee within the Bank would monitor systemic risks. The BOE would be given powers to ensure capital and liquidity requirements account for the riskiness of institutions and would oversee the creation of "living wills" to assist with any wind-downs. The Tories would merge the responsibilities for consumer protection of the Financial Services Authority and the Office of Fair Trading to form a new Consumer Protection Agency (CPA).

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